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REHABILITATION PROGRAMS AS OF MARCH 31, 1992E-1**

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**MEMORANDUM FROM CITY ATTORNEY'S OFFICE TO
CITY AUDITOR'S OFFICE REGARDING
LAWS APPLYING TO HOUSING LOANSF-1**

INTRODUCTION

In accordance with the Office of the City Auditor's 1991-92 Audit Workplan, we commenced an audit of the Low and Moderate Income Housing Fund. As a result of the preliminary survey and risk assessment phases of our audit, we modified the scope of our work. Therefore, the purpose of this report is to provide an assessment of the adequacy of the San Jose Housing Department's controls over its Housing Rehabilitation Programs.

Our audit was conducted in accordance with generally accepted government auditing standards. We limited our work as described in the Scope and Methodology section of this report.

We thank the Housing Department staff and management for their excellent cooperation and responsiveness to our requests for information.

SCOPE AND METHODOLOGY

Our audit work, which resulted in an assessment of the San Jose Housing Department's controls over its Housing Rehabilitation Programs, included three major phases:

- Preliminary Survey,
- Risk Assessment, and
- Controls Testing.

Our first audit phase was the preliminary survey. During this phase, we gathered historical, organizational, legal, and financial information about the Housing Department and its functions. The Department's major source of ongoing funding is an estimated \$14 million per year in new tax increment revenue into the Low and Moderate Income Housing Fund.¹ Our preliminary survey encompassed all of the Housing Department's functions and how the Low and Moderate Income Housing Fund relates to the Department as a whole.

Based on our preliminary survey as well as input from the Mayor, City Council, and City Manager, we narrowed our audit focus to all of the Housing Department's Rehabilitation Programs regardless of funding source.²

¹ The Low and Moderate Income Housing Fund (Fund) is often referred to as the 20% Housing Fund. The primary revenue source for the Fund is 20% of the tax increments the Redevelopment Agency of the City of San Jose receives. State law requires that 20% of redevelopment agency tax increments be spent for the purposes of increasing and improving the supply of low- and moderate-income housing.

² See Appendix C for a table of the various Housing Rehabilitation Programs and their funding sources.

For the purpose of this report, we excluded Project Development, which is one of the Housing Department's other major functions, because:

- The Office of the City Auditor previously covered Project Development in its 1987 report, *An Audit Of The Redevelopment Agency's 20% Housing Program*;
- Rehabilitation Programs involve a greater portion of the Housing Department's staff; and
- There are more Rehabilitation Program loans in the Housing Department's portfolio than loans from any other Housing Department program.

Next, we initiated the risk assessment phase of our audit. The purpose of risk assessment is to identify the threats facing the program under audit and to identify the internal controls the program managers have implemented to prevent, eliminate, or minimize the threats. A threat, in the context of risk assessment, is an unwanted event or occurrence. Internal controls are the plan of organization and methods and procedures adopted by management to ensure that:

- Goals and objectives are met;
- Resources are used consistent with laws, regulations, and policies;
- Resources are safeguarded against waste, loss, and misuse; and
- Reliable data is obtained, maintained, and fairly disclosed in reports.

Internal controls help program managers forestall the three situations that can degenerate into crisis or chaos; namely, overspending, failure of operations, or violations of law.

In conducting the risk assessment of Housing Rehabilitation Programs, we first prepared a list of threats associated with program activities. Then, we

requested Housing Department officials to add any threats they believed existed that were not on the list we provided and to identify the existing internal controls to mitigate the threats. From the Department's response to each threat, we summarized the system of controls in a list that can be seen in Appendix E. We also identified the interrelationship between the threats and the Department's representation of its internal controls in a risk matrix, which is shown in Appendix D.

The identified threats to which the Department responded were divided into the following categories:

- Department goal and performance measure risks
- Staffing and training risks
- Communication and procedure risks
- Management reporting risks
- Records management risks
- Electronic Data Processing (computer environment) process risks
- Rehabilitation Program process risks
 - General/miscellaneous
 - Citizen/contractor inquiries and complaints
 - Application processing
 - Project scope and cost estimating
 - Contractor selection and bidding
 - Credit analysis and funding approval
 - Loan agreement and documentation
 - Construction monitoring
 - Progress payment processing
 - Loan accounting and processing
 - Loan management and collections
 - Compliance review

- U.S. Escrow risks
 - General
 - Contract specific

We reviewed the Housing Department's written policies, procedures, and other documents to determine whether the Department's significant internal controls appeared to be adequately documented. We also assessed, for each threat, whether the Department's controls appeared to be adequate to prevent a threat or mitigate the consequences of a threat should it occur. Finally, we tested the Department's significant internal controls to determine if they were in place and functioning as intended by interviewing Department staff, observing operations, and analyzing and testing the Department's records.

In our report, budget figures cited are current through the 1992-93 Proposed Operating Budget. Other information in our report on the outstanding loan portfolio, program activities and accomplishments, and status of internal controls planned for the future, is current as of March 31, 1992.

It should also be noted that, although we reviewed Rehabilitation Programs funded by the Low and Moderate Income Housing Fund, we did not perform a financial post audit of transactions. However, the Low and Moderate Income Housing Fund is also used for overhead expenditures and to pay for services from other departments that support housing functions. Specific fund uses include payments for City Attorney, Departments of Finance and Planning, and Information Systems Department services, as well as payments related to the City's Financial Management System. We considered the Rehabilitation Program related activities and functions that these other City departments perform during our risk assessment and testing of the Department's internal controls.

The end result of risk assessment is the identification of threats for which no internal controls or insufficient internal controls are in place. By informing Department management of these nonexistent, insufficient, or nonfunctioning internal controls, it can design, document, and implement internal controls to prevent or mitigate the consequences of a threat in the event it does occur.

BACKGROUND

Department Mission

The City of San Jose's Housing Department's mission is *"to preserve and improve the supply of decent, safe and sanitary housing affordable to lower and moderate income families, and where appropriate, to ensure its long-term affordability, and to contribute to neighborhood revitalization."*

According to the City's 1990-91 Annual Report:

The Housing Department provides the funding and technical expertise necessary to encourage quality development and rehabilitation of housing that is affordable to very low to moderate income individuals and families in San Jose. In addition to individual home or multi-family housing projects, the Department has recently begun programs which are designed to impact an entire neighborhood such as the Santee project in the Walnut Grove area.

DEPARTMENT ORGANIZATION AND STAFFING

The Housing Department is divided into seven functional units:

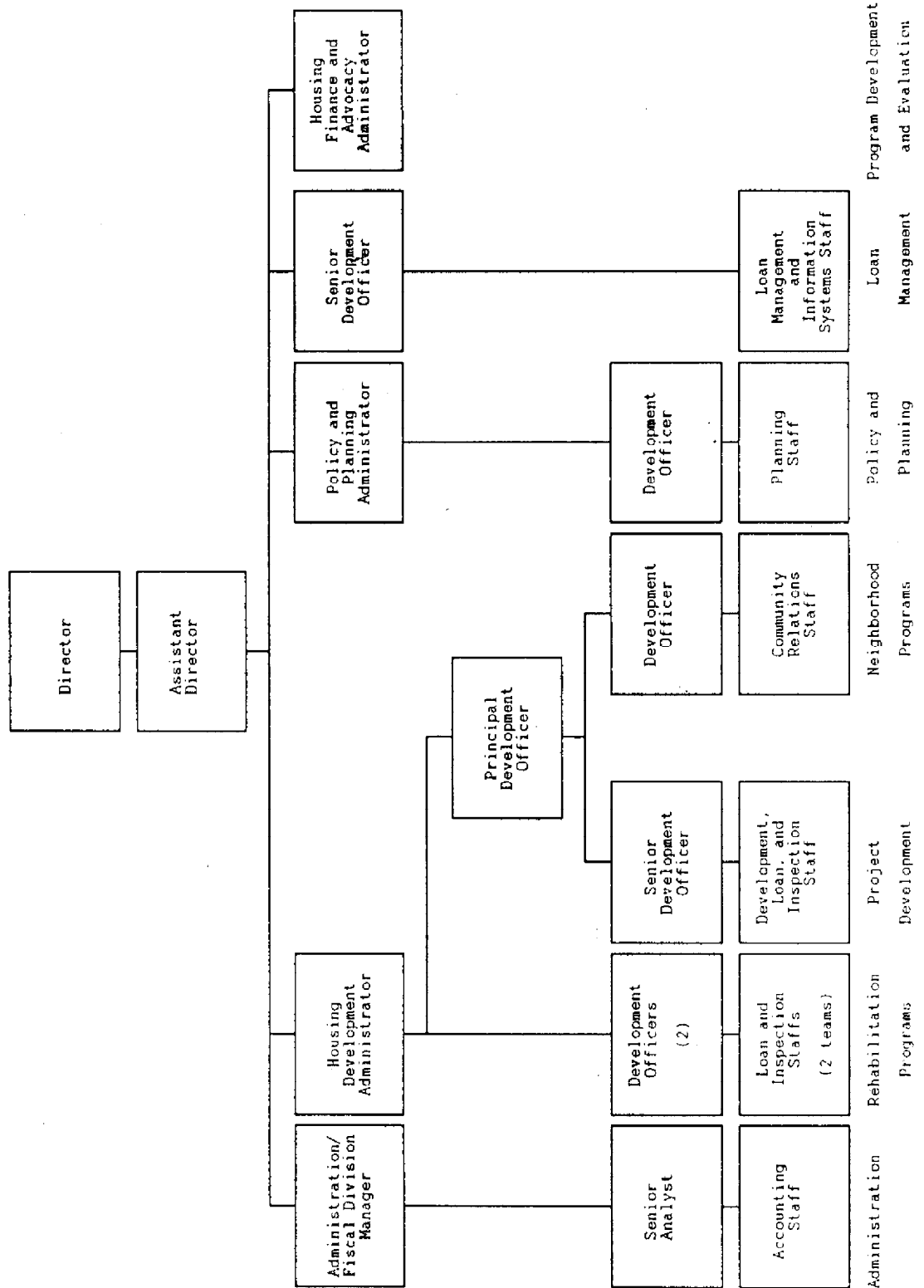
- Administration
- Policy and Planning
- Program Development and Evaluation
- Project Development
- Rehabilitation Programs
- Neighborhood Programs
- Loan Management

The Department's authorized full-time equivalents (FTEs) have increased 84 percent from 41 in 1987-88 to 75.5 in 1992-93. In 1990-91, the Department conducted a review of its organizational structure *"to identify organizational strategies to ensure the stabilization of the Department's growth and employee*

interaction." Chart I shows the Housing Department's organizational structure as of March 31, 1992.

CHART I

HOUSING DEPARTMENT ORGANIZATIONAL CHART AS OF MARCH 31, 1992



DEPARTMENT HISTORY

The San Jose City Council officially established the Housing Department effective December 4, 1987, when it passed Ordinance 22641. Prior to that, housing rehabilitation was a function of the Neighborhood Preservation Department, while the Redevelopment Agency administered project development of new and converted housing units.

Mayor's Task Force On Housing

In August 1987, at the Mayor's request, a Housing Task Force of 17 members was formed to develop a broad-range plan of action to assist the new Department with a five-year plan. The plan was to demonstrate the City's commitment to providing affordable housing for its very low-, low- and moderate-income residents.

The Mayor's Task Force on Housing (Task Force) identified two key program areas to address San Jose's need for affordable housing: (1) expansion of the supply of housing affordable to targeted income groups and (2) the rehabilitation of existing housing units already occupied by targeted income groups. In October 1989, the City Council adopted the Task Force's final report, *San Jose: A Commitment To Housing*. In that report, the Task Force proposed five principal affordable housing goals:

Goal 1	Increase the supply of affordable housing, preserve the housing stock, and reduce the cost of developing affordable housing.
Goal 2	Utilize available resources to address priority needs for housing.
Goal 3	Increase the funds available for preservation and development of affordable housing.
Goal 4	Disperse low-income housing throughout the City to avoid concentrations of low-income households and to encourage racial and economic integration.
Goal 5	Encourage greater involvement of public and private sectors to increase and preserve the stock of affordable housing in San Jose.

The above goals were supported by a series of recommendations, most of which the City Council adopted. Some of the adopted recommendations relate specifically to rehabilitation programs and include the following:

1. *With the exception of funds for Housing Department and nonprofit housing development corporation administration, all 20% housing funds, Community Development Block Grant rehabilitation funds, Rental Rehabilitation funds and other funds not explicitly earmarked by funding source that are available to the City for development of low- and moderate-income housing in San Jose should be distributed by the following percentages:*
 - *60% for very low-income housing;*
 - *25% for low-income housing; and*
 - *15% for moderate-income housing.*
2. *Because housing rehabilitation extends the economic life of housing, the program should be an important element of the City's housing activities.*
3. *The City should retain the policy that one-third of housing funds should be used for housing rehabilitation programs and two-thirds should be used for new housing. The policy should be applied to all funds available to the City for housing, except for funds restricted by funding sources.*
4. *Of the total public funds available for housing rehabilitation, 75% should be used in target areas with 25% for other rehabilitation activities and special hardship cases citywide.*
5. *The City should aggressively seek other sources of revenue (federal, state) to supplement rehabilitation funds.*

Relations With The Redevelopment Agency

By written agreement dated November 10, 1987, the Redevelopment Agency (Agency) delegated to the City of San Jose the Agency's obligation and

authority to administer the 20% Housing Program. The agreement between the City and the Agency "*delineates the purpose and functions of the Housing Department and provides for the orderly transfer of tax increment funds, Agency assets, and personnel dedicated to the 20% Housing Program, as well as Agency obligations incurred under the 20% Housing Program.*"

The Agency and the City have continued the relationship regarding the 20% Housing Program through annual Cooperation Agreements, but recently the City Council and Agency jointly approved a more permanent 20% Housing Cooperation Agreement. This new agreement will remain in effect until either party terminates it. Further, the new agreement permits the City to issue bonds secured by 20% Housing Funds and completes the transfer of functions and personnel to the City.

Additionally, the Agency and City amended the Agreement to provide for the Agency to make payments to a Housing Project Support Fund. These payments are specifically designated for debt service payments on housing bonds. The Agency will pay to the Housing Project Support Fund an amount not to exceed \$6 million per year beginning July 1, 1995, and ending December 31, 2011. These payments represent a significant Agency commitment beyond the required 20% of its tax increments and will define the Agency's participation in low- and moderate-income housing programs for the next several years.³

³ It should be noted that the Agency is also involved in other housing projects. Specifically, the Agency uses some of its 80% share of the tax increment money for market-rate housing primarily in the downtown area.

Housing Stock Inventory

According to the Housing Department:

In general, the [City of San Jose] housing stock is relatively modern and in good condition; as buildings age or are not well maintained, however, one can expect a higher incidence of substandard dwelling units -- units which are unsanitary (e.g., lack of adequate plumbing), hazardous (e.g., deteriorated foundation or electrical wiring in violation of code), or otherwise unsafe for human habitation. . . . While the actual percentage of substandard units is currently unknown, the Department of Housing estimates that between 10% and 15% of the City's housing stock is in need of substantial repair.

Table I shows the Department's estimate of 12,514 renter-occupied units and 19,573 owner-occupied units, for a total of 32,087 units, needing rehabilitation:

TABLE I

**CITY OF SAN JOSE
HOUSING STOCK INVENTORY
BASED ON THE 1990 CENSUS**

Renter Occupied Units	96,861	
12,514 Needing Rehabilitation		
62 Not Rehabbable		
Owner Occupied Units	153,357	
19,573 Needing Rehabilitation		
98 Not Rehabbable		
<i>Total Occupied Units</i>		<u>250,218</u>
Vacant Units For Rent	4,572	
Vacant Units For Sale	2,245	
Vacant Units Unavailable For Occupancy	2,330	
<i>Total Vacant Units</i>		<u>9,147</u>
Total Year-Round Units		<u>259,365</u>

Source: City of San Jose *Final Comprehensive Housing Affordability Strategy* approved by the U.S. Department of Housing and Urban Development, April 2, 1992.

Department Performance Measures

In early 1992, the City Manager's Office Management Analysis Team (MAT) studied the Housing Department's performance measures. The MAT recommended new performance measures to be included in the 1992-93 budget that would be more consistent with the Department's goals and mission. As a result of meetings between the MAT and the Department, 11 new performance measures were developed. These new measures as well as two previously used measures are included in the 1992-93 Operating Budget.

The Department's performance measures address the number of dwelling units approved for rehabilitation loans, the percentage of loan applications processed promptly, and the number of units actually rehabilitated or replaced. The measures also look at the percentage of the number and dollar amount of rehabilitation loans that are delinquent and the percentage of the loan portfolio actively monitored for program compliance.

Recent Changes In Department Activities

The Department has experienced a dramatic increase in both the volume and diversity of its activities. These activities include the following:

- Implementation of 64 of 82 major recommendations made by the Mayor's Task Force on Housing;
- Creation of the expanded housing program in April 1990, which will involve raising \$50 million in bond funds to achieve a 70 percent increase in affordable housing production by 1995;
- Coordination of the City's homeless assistance and prevention programs, such as the Guadalupe River Project and Project Creekside;

- Providing staff support for the Federal Housing Conversion Task Force and the Housing Advisory Commission;
- Implementation of the California Disaster Assistance Program (CALDAP) loan program, which provides state assistance to victims of natural disasters;
- Providing support for concentrated neighborhood improvement programs, such as the Santee Neighborhood Action Center;
- Development of the first Comprehensive Housing Affordability Strategy (CHAS) as required by federal law;
- Direct acquisition of potential housing sites;
- Participation in the Mortgage Credit Certificate program, in cooperation with Santa Clara County; and
- Legislative analysis and advocacy, such as for the revision of housing affordability provisions in state law to enable San Jose and other cities to more effectively leverage their limited housing funds.

BUDGET AND FINANCIAL INFORMATION

Department Operating Budget

In the City's 1992-93 Proposed Operating Budget, the Housing Department is shown under the "Special Revenue Fund" section. The Low and Moderate Income Housing Fund (Fund) is the primary source of funding for the Department's operations, rehabilitation programs, and development projects.⁴ Other revenue sources include bond proceeds, loan repayments, and interest earned in the Fund. In addition, the Department receives and uses Community Development Block Grant

⁴ The Low and Moderate Income Housing Fund (Fund) is often referred to as the 20% Housing Fund. The primary revenue source for the Fund is 20% of the tax increments the Redevelopment Agency of the City of San Jose receives. State law requires that 20% of redevelopment agency tax increments be spent for the purposes of increasing and improving the supply of low- and moderate-income housing.

(CDBG) and Rental Rehabilitation Program (RRP) funds from the federal government for its Housing Rehabilitation Programs.

For budget purposes, the Department is divided into three program areas: Administration, Policy and Planning, and Conservation and Development. The Department's 1992-93 proposed operational budget for these three budget program areas is as follows:

Administration	\$1,343,659
Policy and Planning	766,243
Conservation and Development	<u>3,293,453</u>
Total	<u>\$5,403,355</u>

The *Administration Program* provides the Department's planning, organization, direction, and evaluation activities.

The *Policy and Planning Program* provides housing planning, policy research, policy analysis, legislative advocacy, fund raising, program planning, program development, and program evaluation for the Housing Department.

The *Conservation and Development Program* incorporates four sub-programs:

- a. The ***Housing Project Development*** program's function is to expand the supply of housing affordable to low- and moderate-income households.
- b. The ***Neighborhood Services*** program coordinates delivery of City services to neighborhoods, particularly those characterized by serious blight, overcrowding, and crime problems.
- c. The function of the ***Housing Conservation*** (rehabilitation) program is the preservation of the existing supply of affordable housing through the rehabilitation of dwelling units to ensure that they are safe and sanitary.

- d. The *Loan Management and Monitoring* program provides the management and maintenance of the Department's loan portfolio.

The Low And Moderate Income Housing Fund

Table II shows the sources and uses of the Low and Moderate Income Housing Fund and illustrates the rapid increase in the size of the Fund.

TABLE II
SOURCES AND USES OF THE LOW AND
MODERATE INCOME HOUSING FUND (In Thousands)

	<u>1989-90</u>	<u>1990-91</u>	<u>1991-92</u>	<u>1992-93</u>
	<u>Actual</u>	<u>Actual</u>	<u>Estimated</u>	<u>Proposed</u>
SOURCES:				
Beginning Balance				
Restricted	\$ 1,300	\$ 3,800	\$ 6,700	\$ 3,400
Unrestricted	10,900	17,500	15,200	3,400
Revenue				
Loan Repayments	2,900	1,200	1,800	1,500
Interest	1,300	1,500	1,000	1,000
20% Increment	14,000	14,000	14,400	15,000
Tax Corrections	1,500	0	0	0
Bond Proceeds	0	0	0	30,000
Redevelopment Agency	<u>0</u>	<u>0</u>	<u>1,000</u>	<u>0</u>
Total	<u>\$31,900</u>	<u>\$38,000</u>	<u>\$40,100</u>	<u>\$54,300</u>
USES:				
Rehabilitation Programs	\$ 1,400	\$ 2,900	\$ 2,300	\$ 4,600
Project Development/Other	5,700	8,300	24,300	38,000
Operating Expenditures	3,500	4,800	6,800	8,000
Ending Fund Balance	<u>21,300</u>	<u>22,000</u>	<u>6,700</u>	<u>3,700</u>
Total	<u>\$31,900</u>	<u>\$38,000</u>	<u>\$40,100</u>	<u>\$54,300</u>

Community Development Block Grant

San Jose is an "entitlement city" receiving federal funds under the CDBG program. CDBG monies provide funding for local community projects in accordance with the objective of the federal CDBG program, which is *"to provide assistance to persons of low and moderate income, prevent or eliminate slums and blight, or meet other community needs of an emergency nature."*

In the next five years, the Department will continue to target CDBG funds for moderate and substantial rehabilitation of very low- and low-income rental and owner-occupied units. Table III shows the sources and uses of the CDBG applicable to Housing Rehabilitation Programs.

TABLE III
SOURCES AND USES OF THE
COMMUNITY DEVELOPMENT BLOCK GRANT RELATED
TO THE HOUSING REHABILITATION PROGRAMS (In Thousands)

	<u>1989-90</u> <u>Actual</u>	<u>1990-91</u> <u>Actual</u>	<u>1991-92</u> <u>Estimated</u>	<u>1992-93</u> <u>Proposed</u>
SOURCES:				
Beginning Balance				
Restricted	\$ 360	\$ 290	\$ 340	\$ 220
Unrestricted	2,280	2,570	1,020	350
Revenue				
Entitlement for Rehabilitation	1,580	920	700	450
Entitlement for Relocation	190	450	300	250
Loan Repayments	<u>1,320</u>	<u>1,170</u>	<u>1,350</u>	<u>1,100</u>
Total	<u>\$5,730</u>	<u>\$5,400</u>	<u>\$3,710</u>	<u>\$2,370</u>
USES:				
Transfers*	\$ 130	\$1,410	\$ 240	\$ 0
Rehabilitation Loans	2,580	2,510	2,360	1,900
Relocation Grants	160	130	540	250
Ending Fund Balance	<u>2,860</u>	<u>1,350</u>	<u>570</u>	<u>220</u>
Total	<u>\$5,730</u>	<u>\$5,400</u>	<u>\$3,710</u>	<u>\$2,370</u>

* Transfers are made to other City of San Jose CDBG projects administered outside of the Housing Department.

Rental Rehabilitation Program

The Housing Department receives funds from the federal government for the Rental Rehabilitation Program. Over the past four years, the City has drawn down approximately \$400,000 per year from its RRP allocations. The last allocations of this discontinued HUD program were made at the end of federal fiscal year 1990-91. San Jose anticipates expending the remainder of its RRP allocation in 1992-93.

Loan Portfolio Analysis

As of June 30, 1991, \$25.4 million in 1,052 outstanding housing rehabilitation loans represented 39 percent of the amount and 84 percent of the number of the Department's total loans. The remaining loans were developer or second mortgage loans. By March 31, 1992, the outstanding rehabilitation loan portfolio decreased slightly to 914 loans totaling \$25.2 million. This \$25.2 million was funded as follows:

CDBG Funds	\$12,864,970	51%
HUD Rental Rehabilitation Funds	2,156,349	9%
20% Housing Fund	<u>10,142,910</u>	<u>40%</u>
Total	<u>\$25,164,229</u>	<u>100%</u>

Further, of the total \$25.2 million outstanding, amortizing loans with payments due were \$12.5 million, while loans with payments deferred were \$12.7 million. The average outstanding rehabilitation loan as of March 31, 1992, was \$27,500.

DESCRIPTION OF HOUSING REHABILITATION PROGRAMS

Current Active Programs

The Department has had a number of individual programs since 1988 under the heading of housing conservation, preservation, or rehabilitation. The Department discontinued some of these programs and evolved others into newer versions. The remaining Housing Rehabilitation Programs for which new applications will be accepted include the following:

- **Housing Preservation Program (HPP)** - Rehabilitation or replacement of owner-occupied, single-family units and duplexes.
- **Rental Housing Rehabilitation Program (RHR)** - Rehabilitation of non-owner occupied rental housing.
- **Mobilehome Repair Loan Program (MRLP)** - Repair of mobilehome units.
- **Housing Emergency Loan Program (HELP)** - Loans up to \$5,000 to low- or very low-income and nonprofit property owners for immediate threats to health and safety (includes ownership and rental housing).
- **Paint Rebate Program (PRP)** - Grants up to \$3,000 to owners of single-family units for exterior repainting.

In Appendix C is a more extensive listing of rehabilitation programs and their funding sources, including recently or soon to be discontinued programs.

The Rehabilitation Program Process

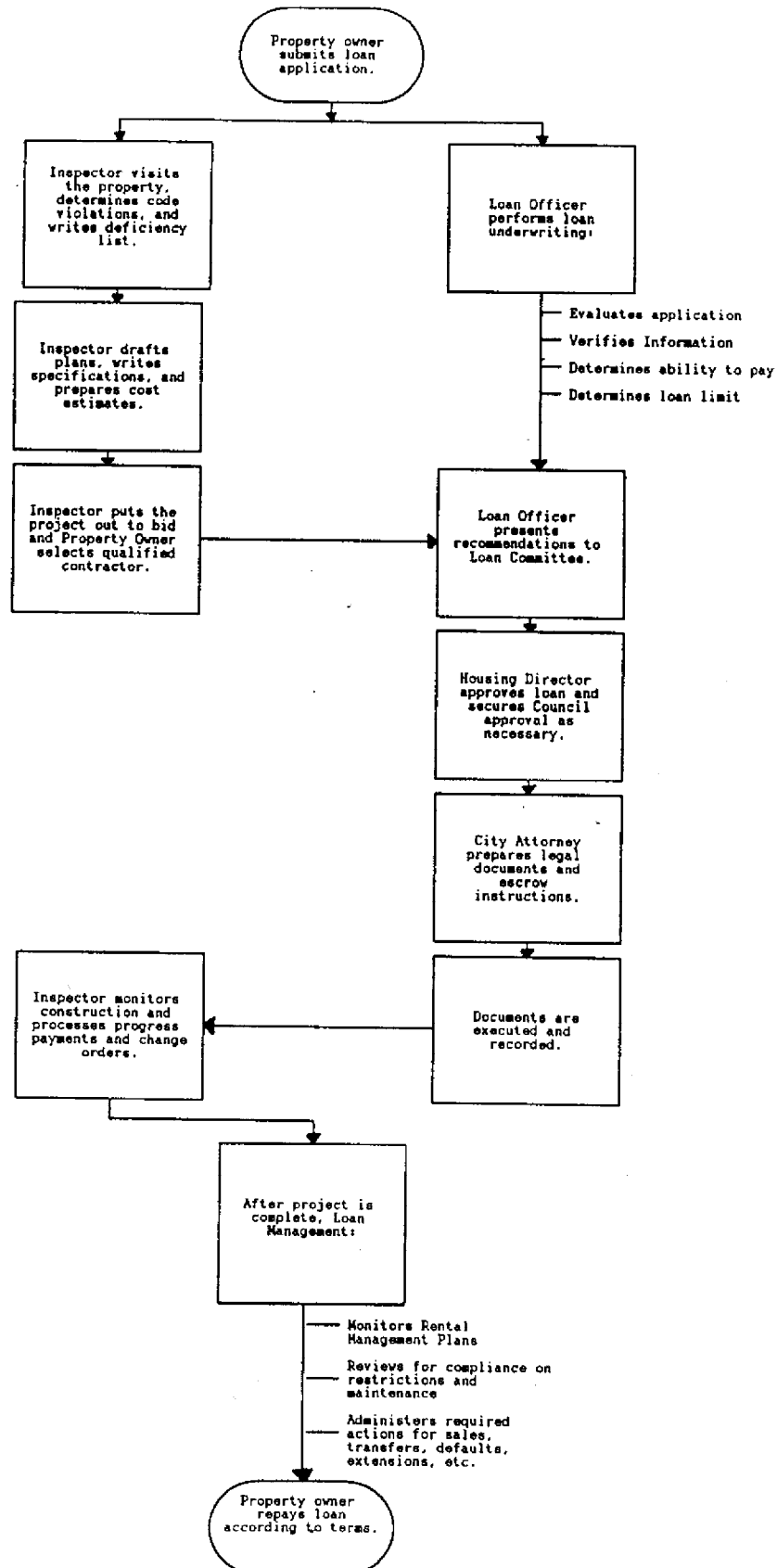
The Housing Department reorganized the rehabilitation program staff in April 1991. Under the previous organization, staff was organized by type of work. For example, loan underwriters reported up a separate chain of command than did

rehabilitation inspectors. Under the new organization, the staff is organized into teams of underwriters and inspectors. According to Department officials, *"This new organization is intended to improve communication at the production-staff level and to encourage decision-making at that level."*

Additionally, the process for any rehabilitation loan application and construction project now follows a "parallel process" instead of a linear sequence for certain activities. This means that cost estimating and loan underwriting procedures are performed at the same time, thereby shortening total processing time. Chart II is a flowchart that illustrates the rehabilitation program parallel process and key activities from the time of application to loan repayment.

CHART II

FLOWCHART OF THE REHABILITATION PROGRAM PARALLEL PROCESS



Application Backlog

Due to past inefficiencies in the rehabilitation program loan application process, the Department accumulated a large backlog of unprocessed applications. As a result, the Department stopped accepting rehabilitation applications for single family, owner-occupied units in May 1991. Instead, the Department asked interested parties to fill out an interest card. The Department then used the interest cards to notify interested parties when the Department once again began taking new applications.

Between May 1991 and February 1992, the Department issued interest cards and accumulated a waiting list of 213 potential rehabilitation loan applicants. The Department sent letters to all these persons, and 140 persons responded saying they were still interested in receiving an application. As of the end of May 1992, the Department had mailed the 140 applications and began interviews to determine applicant eligibility. All the new loan applications are processed under the Department's new parallel process.

By June 1992, the Department expects to have processed all the applications that resulted from the old backlog and the 1991-92 interest cards. In 1992-93, the Department plans to use the interest card process as a buffer to prevent information on loan applications from becoming stale before processing. Thus, "walk-in" applicants would be asked to complete either an application or an interest card depending on the Department's ability at that time to process an application promptly. In the instance where the applicant was given an interest card, a letter and application package will be sent later.

Program Production Numbers

The Mayor's Task Force on Housing (Task Force) established a target of directing the expenditure of 75 percent of City housing rehabilitation funds to identified target areas, with the remainder being available for other rehabilitation activities and special hardship cases citywide. In 1991-92 (through March 31, 1992), 68 percent of program expenditures have been expended in target areas compared to 80 percent for 1990-91.

The Task Force also established a five-year production target, based on the anticipated availability of funding for rehabilitation of between 752 and 1,729 housing units. This five-year target equates to between 150 and 346 units per year.

Recent production statistics for the number of units rehabilitated show the following:

	<u>Single-Family Rehab</u>	<u>Rental Rehab</u>	<u>Mobilehome Rehab</u>	<u>Paint Grants</u>	<u>Infill</u>	<u>Total</u>
1989-90	70	34	23	99	17	243
1990-91	<u>55</u>	<u>111</u>	<u>16</u>	<u>103</u>	<u>1</u>	<u>286</u>
Total	<u>125</u>	<u>145</u>	<u>39</u>	<u>202</u>	<u>18</u>	<u>529</u>

During these two years, the Department expended \$10,297,730 for all of these categories.

Housing officials further summarized the Department's efforts in the two-year period, stating that:⁵

- *Rehabilitation of multi-family rental housing in 1990-91 was concentrated in two Project Crackdown neighborhoods: Santee/Walnut Grove and Via Monte/Hoffman Court. Loan approvals for multi-family housing rehabilitation increased from 34 units in 1989-90 to 111 units in 1990-91, primarily in these two Project Crackdown areas.*
- *Performance in terms of production, measured against the rehabilitation objectives established by the Mayor's Task Force on Housing, was disappointing. The number of units rehabilitated (that is, excluding paint grants and infill construction) was 127 dwellings in 1989-90 and 182 in 1990-91, averaging 155 per year. Although this falls within the parameters established by the Task Force (between 150 and 345 units per year), it is clear that production needs to increase if significant progress is going to be made in reducing the amount of substandard housing.*

From July 1, 1991, through March 31, 1992, the Department approved loans of nearly \$3.1 million in City funds (excluding CALDAP Funds) to rehabilitate a total of 144 dwelling units (excluding paint grants). For the same period in 1990-91, the Department approved rehabilitation loans totaling \$2 million. Thus, in the first nine months of 1991-92, the Department approved 55 percent more dollars for rehabilitation projects than it did during the same period in 1990-91.

⁵ It should be noted that ultimately a final assessment of the Department's performance in meeting production targets will be on a five-year basis. The five-year period includes 1989-90 through 1993-94.

LAWS AND REGULATIONS AFFECTING
HOUSING REHABILITATION PROGRAMS

Federal And State Statutes
Applicable To Housing Loans

The City Attorney's Office prepared a listing of federal and state statutes applicable to housing loans. See Appendix F for this list of laws applying to housing loans. It should be noted that all the statutes listed may not necessarily apply to rehabilitation loans.

In addition, Housing Rehabilitation Programs are subject to the state Community Redevelopment Law. Some major sections are:

Section 33334.2 - Describes that not less than 20% of all taxes that are allocated to the agency shall be used by the agency for the purposes of increasing, improving, and preserving the community's supply of low- and moderate-income housing available at affordable housing cost. In carrying out the purpose of this section, the agency may exercise any or all of its powers to:

- Acquire property
- Improve property
- Donate property
- Finance insurance premiums
- Construct buildings or structures
- Rehabilitate buildings or structures
- Provide subsidies to households
- Pay financing costs

Section 33334.3 - States that funds shall be held in a separate Low and Moderate Income Housing Fund. The section describes various rules for the Fund. For example, administrative costs cannot be disproportionate to the production costs.

Section 33334.4 - Describes the proportion of units for which the agency should strive to expend the Fund.

Section 33334.5 - Describes replacement dwelling requirements. When dwellings are destroyed due to a redevelopment project, the units must be replaced in four years.

Section 33334.10 - States that the agency shall separately account for each excess surplus either as part of or in addition to a Low and Moderate Income Housing Fund. The agency may adopt a plan for expenditures of monies in the Fund.

Section 33334.12 - States that, upon failure of the agency to expend or encumber excess surplus in the Low and Moderate Income Housing Fund within five years from the date the monies become excess surplus, within the meaning defined in **Section 33334.10**, the agency shall disburse that excess surplus to the Santa Clara County Housing Authority.

Section 33334.13 - Defines area median income. The section also designates that units must remain at affordable housing costs for at least ten, fifteen, or thirty years depending on whether they are rental or owner-occupied and whether they are inside or outside of "merged redevelopment areas."

Section 33418 - Defines monitoring requirements.

City Municipal Code

Several sections of the Municipal Code govern the operations of the Department and its Housing Rehabilitation Programs. Among these are:

Section 2.04.1700 - Creates the Housing Department and states the functions, powers, and duties of the Director of Housing.

Section 2.08.4100 to 2.08.4150 - States the powers, functions, and duties of the Housing Advisory Commission.

Section 4.80.2200 to 4.80.2240 - Creates the Low and Moderate Income Housing Fund and discusses the authorized deposit, expenditure, and transfer of monies.

Title Five (Sections 5.01.010 to 5.06.260) - Sets forth additional Housing Department guidelines, regulations, and policies relating to the provision of affordable housing in the City of San Jose. This section also includes the Director of Housing's contract authority ("Delegation of Authority") and outlines certain reporting requirements.

City Council Resolutions

There have been a number of City Council resolutions related to the Housing Department. Some of the more significant resolutions are:

Resolution 61969 - Approves the Loan Default Policy, which authorizes the Director of Housing to take appropriate action to *"remedy loan defaults including foreclosure action; use funds currently appropriated to the Department of Housing to establish an emergency fund in the amount of \$300,000 to cure loans in default; contract with third party services to remedy loan defaults and process foreclosure actions."*

Resolution 62243 - Approves a proposal to do joint venture funding with Bayview Federal Savings. (However, it was not implemented.) It authorizes *"the Director of Housing to execute necessary agreements, and any amendments thereto, with lending institutions qualified to participate in the City of San Jose's Comprehensive Low Interest Residential and Commercial Rehabilitation Loan Programs and approving the use of 20% tax increment fund for such programs."*

Resolution 62469 - Defines the Delegation of Authority limits for the Director of Housing to approve certain housing loans.

Resolution 62502 - Approves *"a cooperation agreement with the Redevelopment Agency of the City of San Jose regarding 20% Housing."*

Resolution 63159 - Authorizes the City to execute *"a Memorandum of Understanding with the Santa Clara County Housing Authority for purposes of carrying out the local administration of the Rental Rehabilitation Program."* (This is a federal program.)

Resolution 63257 - Provides for administration of a special HUD program to rehabilitate units damaged in the 1989 earthquake and an agreement with the Santa Clara County Housing Authority for "moderately" expensive rehabilitation.

City Council Policy For Rehabilitation Cost Control

In January 1992, City Council passed the "80-10-10" policy *"as a means of imposing program-wide cost controls. Under this policy, 80% of funds expended for rehabilitation are targeted to projects costing less than \$55,000 per unit, 10% to projects costing between \$55,000 and \$75,000 per unit, and 10% to projects exceeding \$75,000 per unit."*

As of March 31, 1992, expenditures in the more than \$75,000 per unit category exceeded the 10 percent target. The Department compensated for this by underexpending funds in the \$55,000 to 75,000 per unit category. As of March 31, 1992, the Department had committed funds for 1991-92 as follows:

<u>Rehabilitation Cost Per Unit</u>	<u>1991-92 Funds Committed⁶</u>	<u>Percentage Of Funds Committed</u>	<u>Policy Target</u>
Under \$55,000	\$1,915,000	83%	80%
\$55,000 - \$75,000	0	0%	10%
More than \$75,000	<u>379,000</u>	<u>17%</u>	<u>10%</u>
Total	<u>\$2,294,000</u>	<u>100%</u>	<u>100%</u>

Because of a concern that the \$55,000 to \$75,000 per-unit range might be too narrow to be meaningful, the City Council recently approved a revision to the

⁶ Funds Committed figures are for the nine months from July 1, 1991, through March 31, 1992.

cost control policy at its August 25, 1992, meeting. Accordingly, the 80-10-10 formula is changed to an 80-20 formula whereby 80 percent of rehabilitation funds should be targeted to projects costing less than \$55,000 per unit, with the remaining 20 percent to projects of \$55,000 or more.

Housing Advisory Commission

On December 15, 1989, the City Council established a seven-member Housing Advisory Commission (HAC) to study, review, evaluate, and make recommendations to the City Council and the Housing Department on existing and new housing programs and policies. The Department provides staff services to the HAC, which meets monthly.

DEPARTMENT ACCOMPLISHMENTS

Overall, the Department has an adequate system of controls over its Housing Rehabilitation Programs and actively incorporates a number of good management techniques. Since the Department's creation, it has recognized the need to restructure and improve many of its policies and procedures. The Department's system of controls emphasizes preventive controls 3-to-1 over detective controls⁷. While the Department has a sizable number of controls already in place, it plans to implement several new controls within the next year.

⁷ Sawyer's Internal Auditing describes *preventive controls* as those that "are installed to prevent undesirable outcomes before they happen" and *detective controls* as those that "are designed to identify the undesirable outcomes when they do happen". Additionally, preventive controls "forestall errors and thereby avoid the cost of correction" while detective controls "measure the effectiveness of the preventive controls" and detect errors when they occur.

Although the Department is subject to a significant degree of oversight from outside parties, it primarily depends on its own internal controls to achieve its objectives. The Department's system of controls includes those required by law or regulation and those which are part of a required standard or automated accounting system. Most of the Department's controls involve things such as standardized forms or administrative procedures and processes.

In 1990-91, the Department conducted a review of its organizational structure and staffing and implemented several major changes to accommodate the growing number of rehabilitation projects. These changes included:

- Increased staffing to handle a larger volume of applications and approved projects;
- Establishment of a separate Loan Management section within the Department; and
- Creation of rehabilitation teams, comprised of loan officers and rehabilitation inspectors, to improve coordination and increase production in the Department's rehabilitation programs.

In April 1991, the Housing Department began working to improve the City's Housing Rehabilitation Programs. The Department identified four distinct issues that required improvement:

- *The need to increase production of units rehabilitated each year to more effectively address the substantial amount of substandard housing in the community identified by the Mayor's Task Force on Housing and to fully utilize available resources, including Community Development Block Grant (CDBG) and 20% Tax Increment funds.*
- *The need to reduce the per-unit cost of rehabilitation in order to make more effective use of resources available for the City's housing programs*

and to assist more San Jose residents to bring their units to a safe and sanitary standard.

- *The need to reduce loan application processing time to both provide better services to loan applicants and to improve productivity by reducing the staff time devoted to each application.*
- *The need to improve service to the clientele served by the Rehabilitation Program. A key customer service objective is providing applicants with a clear understanding at the beginning of the process of what loan terms and scope of work to expect from the program as well as the steps involved in the rehabilitation process.*

In addition, the Department identified other weaknesses in its own operations, such as:

- Outdated written policies and procedures;
- The lack of a comprehensive management information system;
- The lack of comprehensive loan monitoring policies and procedures; and
- Inadequate housing program development and evaluation functions to accommodate increased volume and expectations.

As a result, the Department acted to improve its program effectiveness and responsiveness to residents by increasing production, lowering costs, shortening processing times, and strengthening program management and evaluation. Some of the specific steps the Department took included:

- Reducing the scope of rehabilitation work qualifying for City funding (especially for single-family projects).
- Revamping the organizational structure and administrative procedures for greater efficiency and accountability.

- Establishing program-wide cost-control objectives based on per unit cost of rehabilitation work.
- Preparing a detailed proposal for a new program emphasizing a neighborhood focus for Council approval.
- Reviewing the administration of the Housing Department's Rehabilitation Loan Programs and formalizing the policies and procedures in writing.
- Training staff in loan underwriting.
- Reviewing and improving the credit management process in order to minimize the City's risk as a lender and to ensure that specific policy objectives, such as long term property affordability, are met.

In 1992-93, the Department will continue to focus on improving its ability to manage growth by:

- Designing and implementing a new management information system;
- Providing customer service training to its staff; and
- Using team building exercises and participatory management.

The Department's memorandum describing program accomplishments in its own words is included in this report as Appendix B.

FINDING I

THE HOUSING DEPARTMENT CAN MINIMIZE ITS RISK AND IMPROVE ITS CONTROLS BY RENEGOTIATING ITS LOAN SERVICING AGREEMENTS AND MAKING ITS QUARTERLY DELEGATION OF AUTHORITY REPORT TO COUNCIL CONFORM WITH MUNICIPAL CODE REQUIREMENTS

The Housing Department has various legal commitments resulting from Municipal Code requirements and agreements the Department has entered into with loan servicing agencies. As part of our audit we reviewed selected agreements, supporting documents, and procedures for compliance with these legal commitments. Our review disclosed that:

- The Housing Department needs to renegotiate its agreements with U.S. Escrow and Continental Community Funding;
- The City is losing about \$10,400 in interest annually because \$160,000 of City funds on deposit with U.S. Escrow and Continental Community Funding are in non-interest bearing accounts; and
- The Housing Department's quarterly delegation of authority report submitted to Council is not in accordance with Municipal Code requirements.

As a result, the Housing Department is dealing with a provider of service under a terminated agreement, is losing potential interest revenues, and is not adequately reporting its activities.

Housing Needs To Renegotiate Agreements With U.S. Escrow And Continental Community Funding

The Housing Department needs to renegotiate and execute new agreements with U.S. Escrow (USE) and Continental Community Funding (CCF). The

Department of Neighborhood Preservation executed the two USE agreements, which deal with the administration of the Housing Department's loan portfolio, in October 1986 and November 1986. The October 1986 USE agreement deals with general loan servicing; whereas, the November 1986 USE agreement deals specifically with the Rental Rehabilitation Program (RRP). The CCF agreement expired on December 17, 1989, and has not been renewed. Although the City is not funding new loans through CCF, the City is still collecting on loans previously funded.

The U.S. Escrow Agreements

Under the terms of the October 1986 and November 1986 agreements, USE administers the Housing Department's amortizing rehabilitation loan portfolio. As of March 31, 1992, the amortizing rehabilitation loans totaled approximately \$12.5 million of which \$1.7 million related to the RRP. Our review of the November 1986 agreement, covering the RRP, disclosed that certain provisions may be outdated or inaccurate. However, the loan servicing relationship between the City and USE will be significantly different in the future because the federal government has discontinued new entitlements for the RRP. USE will continue to collect RRP loan repayments and will service new loans funded from these repayment amounts collected. Because these activities are compatible with the activities covered under the October 1986 general USE agreement, a separate RRP agreement may not be necessary. Therefore, the Housing Department should renegotiate one master agreement with USE which includes all loan servicing activities.

Additionally, our review revealed that the City's independent auditor expressed concerns regarding the controls over USE operations. The Housing Department should address these concerns when it renegotiates the City's agreement with USE. Specifically, in its letter regarding *Comments and Recommendations on the Internal Control Structure* dated November 7, 1991, KPMG Peat Marwick discussed the importance of obtaining a third-party review of USE operations:

U.S. Escrow (USE) is currently servicing the amortizing rehabilitation loan portfolio for the Housing Department. As USE is responsible for receiving loan payments and remitting those payments to the Housing Department, it is essential that USE be subjected to an independent monitoring process to verify the adequacy of its controls, and to help prevent errors in the processing of rehabilitation loans and payments which are reflected in the City's general ledger. We understand that the Housing Department has received audited financial statements from USE which include additional agreed-upon procedures and reports relative to USE's escrow activities. In addition, we are aware that Housing Department personnel requested a copy of USE's third-party review report, but were informed that USE does not obtain such a report since it is not legally required to do so. . . Within the mortgage banking industry it is common practice for loan servicing agents to obtain an independent third-party review of their internal control procedures. The reports on these reviews can then be distributed to their customers to demonstrate compliance with various requirements and satisfy audit needs, when necessary. As USE is acting as a loan servicing agent for the Housing Department, we suggest that the Housing Department include a third-party review requirement in its upcoming contract negotiations with USE.

The Continental Community Funding Agreement

The December 1987 *Leveraged Lending Agreement for Rehabilitation Loans* between the City and Continental Community Funding (CCF) deals with funding participation for rehabilitation loans. Under the participation arrangements, CCF lent 67 percent of the funds, while the City lent 33 percent. The City's latest

agreement with CCF expired on December 17, 1989. The City has not renewed its agreement with CCF.⁸

Originally, the City funded about 30 loans in cooperation with CCF. U.S. Escrow collects payments on these loans and forwards the payments to CCF. Although the City is not entering into new loans with CCF, the City still has a business relationship with CCF. Accordingly, any transactions with CCF should be covered by a current agreement.

Additionally, our review disclosed the following provisions in the lapsed Agreement that were inconsistent or did not reflect actual practice:

1. Agreement provisions regarding return of City assets in case of the contractor's insolvency need to be clarified. The agreement does not mention the return of the three depository accounts (Operating Account, Investment Account, and Loan Loss Reserve Account) in case of the contractor's insolvency. In our opinion, the City should seek a provision to safeguard the deposits in case the contractor cannot continue to operate.
2. Agreement provisions regarding record retention should agree with the City's expectations. The City expects documents supporting approved loans to be maintained for the term of the loan or until the loan is paid off. This can be as long as 30 years. However, Page 7 of the agreement requires the lender to retain the documents for only seven years. In our opinion, the City should ensure that the new agreement requires adequate retention periods for loan documents.
3. Agreement provisions regarding the City's Letter of Credit with HUD should reflect actual practice. Our review revealed that the provisions at

⁸ It should be noted that the City is currently not initiating any new loans with CCF because the City has adequate funding from other sources, such as the 20% redevelopment tax increment funds. However, collection of payments on previously funded loans continues.

Item C of the agreement and Section 1 of the First Amendment do not appear to reflect current practice. The agreement states, "*At the termination period of the Agreement, all non-obligated funds remaining on deposit shall be returned to the City's Letter of Credit with HUD, unless the City is authorized by HUD to extend the Agreement for an additional period.*" However, in practice the Department received an extension at the same time that the funds were returned to the City's Letter of Credit with HUD. In our opinion, the new agreement's provisions should reflect actual practice.

4. The definition for reserve account balances needs to be clarified. Pages 2 and 9 of the agreement describe the reserve account balance. The two provisions appear to give differing descriptions of this balance. Housing Department personnel stated that the definition on Page 2 is used when the loan is originated, and the definition on Page 9 is used for ongoing maintenance of the loan. In our opinion, this should be clarified in the new agreement.
5. The Agreement does not contain provisions that give the City of San Jose the right to audit. CCF holds City of San Jose funds and therefore has a fiduciary responsibility to the City. However, without explicit access to CCF records, the City cannot assess how CCF is fulfilling its responsibilities. Accordingly, the City should have access to appropriate CCF records. Additionally, the City should have a contractual right to inspect, audit, and reproduce any CCF records necessary to evaluate and verify CCF's performance under the new agreement. In our opinion, a "right to audit" clause should be included in the new agreement.

To ensure that the City is adequately protected with regard to its funding participations with CCF, the Housing Department should renew its agreement with CCF and correct any unclear or inconsistent provisions.

Reserve And Depository Accounts Are Not Adequately Covered Under The Agreements

The City had about \$250,000 in Reserve and Operating Accounts with USE and CCF as of March 31, 1992. Of this amount, the City was not earning interest on approximately \$160,000 and therefore was losing about \$10,400 in interest annually. Furthermore, the City's agreement with USE does not require such deposits, and although they are required in the CCF agreement, the CCF agreement is expired.

USE retains City funds of approximately \$53,000 in a non-interest bearing Reserve Account. The funds in this account represent the initial loan payment for each amortizing rehabilitation loan. USE retains these funds as a reserve in case a customer's check bounces. This is necessary because USE routinely remits loan payment collections to the City before checks have cleared customer bank accounts. USE returns the funds in the Reserve Account to the City as individual loans are paid off. The City's current agreement with USE does not cover this practice.

The City has with CCF approximately \$109,000 in a non-interest bearing Operating Account and \$88,000 in an interest-bearing Reserve Account. The City's agreement with CCF that describes and requires these accounts and their attendant deposits has expired.

The CCF non-interest bearing Operating Account is used for posting the loan payments CCF receives from USE. However, CCF has not forwarded all of these payments to the City. Accordingly, CCF should return \$109,000 in the Operating Account to the City.

CCF holds \$88,000 in a Reserve Account to cover possible loan defaults. The City's agreement with CCF has a formula that prescribes the Reserve Account balance. According to the Housing Department's accounting staff, CCF has used the Reserve Account to cover defaults only once or twice.

In our opinion, the Housing Department should pursue the following with regard to the USE and CCF Reserve and Operating Accounts:

- Secure the immediate return of available funds to the City;
- Limit the amounts in these accounts to the minimum;
- Place all City funds in interest-bearing accounts; and
- Include all terms and conditions relating to these Reserve and Operating Accounts in agreements with USE and CCF.

**The Housing Department's Quarterly Delegation
Of Authority Report Submitted To Council
Does Not Conform With Municipal Code Requirements**

Housing submits its *Report On Activities Undertaken By The Director Of Housing Under The Director's Delegation Of Authority*, quarterly to the City Council in accordance with Municipal Code Section 5.06.260 (Ordinance 23589). This Section requires the Director to report specific details for all the loans the Director approved. Specifically, Section 5.06.260 states:

The director of housing shall file with the city council a quarterly report which describes all contracts, loan documents, amendments and federal and state applications entered into by the director of housing in the preceding calendar quarter. The report shall identify the subject matter of the contract, loan document or amendment, the person(s) or entity(ies) with whom the contract, loan document, or amendment was made and a summary of the terms of each contract, loan document and application. [Emphasis added.]

Following the City Council's adoption of Ordinance 23589 in September 1990, the Housing Department started issuing reports on the Director's delegated authority activities. Our review of the reports from September 1, 1990, through March 31, 1992, disclosed that, while they contained the details of contract amendments to project development loans the Director authorized after City Council approval, they did not provide either the details of, or a summary of, all the loans the Director solely authorized under his delegated authority.

For example, the Housing Department did not include the following rehabilitation loans in its reports on the delegation of authority activities covering July 1, 1991, through March 31, 1992:

- \$2,326,055 in 79 new loans approved for the rehabilitation or replacement of 127 housing units.
- \$52,819 in increases to 9 rehabilitation loans previously approved under the delegation of authority.

In our opinion, the omission of these loans and changes of terms constitutes a noncompliance with Municipal Code Section 5.06.260. In the future, the Director of Housing should include in his quarterly report to the City Council the terms of each contract, loan, or application the Director authorized.

CONCLUSION

The Housing Department has various legal commitments resulting from Municipal Code requirements and agreements the Department has entered into with loan servicing agencies. We reviewed the Department's agreements, supporting documents, and procedures for compliance with these legal commitments. Our review disclosed that the Housing Department needs to

(1) renegotiate or renew its agreements with USE and CCF, (2) ensure that the City's Reserve and Operating Accounts are adequately covered under the City's agreements, and (3) submit quarterly delegation of authority reports to the City Council in accordance with Municipal Code requirements.

RECOMMENDATIONS

We recommend that the Housing Department:

Recommendation #1:

Renegotiate the City's agreements with U.S. Escrow and Continental Community Funding. Such negotiations should result in current contracts with U.S. Escrow and Continental Community Funding that address:

- Unclear or inconsistent provisions in the previous contracts; and
- Requirements for a third-party review of operations.

(Priority 3)

Recommendation #2:

Pursue the following with regard to the U.S. Escrow and Continental Community Funding Reserve and Operating Accounts:

- Secure the immediate return of available funds to the City;
- Limit the amounts in these accounts to the minimum;
- Place all City funds in interest-bearing accounts; and
- Include all terms and conditions relating to these Reserve and Operating Accounts in agreements with U.S. Escrow and Continental Community Funding. (Priority 2)

Recommendation #3:

Include in reports of activities undertaken by the Director under delegated authority in accordance with Municipal Code Section 5.06.260 the terms of each contract, loan, or application the Director authorized. (Priority 3)

FINDING II

THE HOUSING DEPARTMENT CAN ENHANCE ITS SYSTEM OF CONTROLS OVER THE REHABILITATION PROGRAMS BY IMPROVING PROJECT DOCUMENTATION, CONTRACTOR EVALUATIONS, LOAN ACCOUNTING, AND ITS ELECTRONIC DATA PROCESSING CONTINGENCY PLAN

The Housing Department's system of controls over its Housing Rehabilitation Programs is extensive, and it actively incorporates a number of good management techniques. The Department has identified and implemented most of the internal controls needed to mitigate the threats we identified during our risk assessment of the Housing Rehabilitation Programs. However, we reviewed the use of certain controls in practice and identified areas for improvement. Specifically, our review disclosed that:

- The Housing Department does not have adequate documentation of contractor pre-screening interviews, bid evaluations, and description of work approvals;
- The Housing Department does not evaluate contractor performance as a basis for deciding whether to continue using the same contractors in the future;
- Neither the Housing Department nor the Finance Department are fully reconciling subsidiary rehabilitation loan ledgers and other detail loan listings to the City's general ledger or to each other;
- The Housing Department does not have a policy to identify and write off uncollectible loans; and
- The Housing Department's Electronic Data Processing (EDP) contingency plan is not adequate and does not consider all the major computer systems used by the Department.

The Housing Department can improve its system of internal controls over its Rehabilitation Programs by (1) documenting contractor pre-screening interviews, bid evaluations, and description of work approvals, (2) evaluating contractor performance, (3) coordinating with the Finance Department to eliminate duplicative detail loan listings and fully reconcile subsidiary rehabilitation loan ledgers to the City's general ledger, (4) developing a policy to identify and write off uncollectible loans, and (5) preparing an EDP contingency plan covering all the major computer systems used by the Department.

**The Housing Department's System
Of Controls Over Its Rehabilitation Programs**

As a result of our risk assessment of the Housing Department's Rehabilitation Programs, we identified 208 threats (unwanted events and occurrences) associated with the programs' activities. We provided a list of these threats to the Housing Department, who, in turn, identified 375 existing and 35 planned controls to prevent or mitigate the consequences of the threats should they occur. Then, we tested 192 significant existing controls to determine if they are in place and functioning as intended by interviewing Department staff, observing operations, and analyzing and reviewing the Department's records. Appendix D summarizes the results of our tests.

In general, we found that the Housing Department's system of controls over its Housing Rehabilitation Programs is extensive and incorporates a number of good management techniques. We are satisfied that the Department has identified and implemented most of the internal controls needed to mitigate the threats we identified. However, our audit disclosed certain areas in which the Department can develop or improve its controls. In this finding, we discuss the areas for improvement along with our recommendations.

**The Housing Department Does Not Have Adequate
Documentation Of Contractor Pre-screening
Interviews, Bid Evaluations, And Description Of Work Approvals**

The Housing Department maintains project files that contain documentation of cost estimating, bidding, construction, and inspection activities. We performed a limited test of the documentation in the project files. Our review of project files revealed:

1. No documentation that conflict of interest issues are covered at the contractor pre-screening interview. Housing Department procedures require that *"the screening of all contractors who request participation in the program includes an interview with a Building Rehabilitation Supervisor. This interview includes a frank discussion of the City's position on conflict of interest and acceptance of gifts."* We did not find evidence that the Supervisor discussed the City's position on conflict of interest and acceptance of gifts with all contractors who requested participation in the Rehabilitation Program projects reviewed. The evidence that we found was limited to discussions with the contractors actually selected for projects. To ensure that the contractor pre-screening interviews cover conflict of interest and other important issues, the Department should use a checklist of topics and request each contractor applicant to sign the checklist.
2. No documentation of the Rehabilitation Inspector's review of contractor line item bids. Housing Department procedures require that Inspectors review in detail all contractor bids submitted. Our review indicated that the Department does not maintain evidence that the Inspector performed a line item comparison of bids submitted to the cost estimate. The Inspectors compare each line item and the total bid amount to the cost estimates prepared by Housing personnel to verify that the contractor has looked at all specifications and included reasonable amounts in the total cost. However, the Department does not maintain documented evidence of the Inspector's verifications. To ensure that the total cost includes reasonable amounts for all specifications, Housing should require

Inspectors to document the performance of line item comparisons of the bids submitted to the cost estimate.

3. No documentation of the Rehabilitation Supervisor's approval on the description of work. Department procedures require that the Rehabilitation Supervisor review and approve the description of work prepared by the Inspector. The Supervisor reviews the description of work for errors or omissions. Our review indicated that the standardized description of work form does not contain a preprinted line for the Supervisor's signature. To ensure that the Supervisor reviews and approves the description of work, Housing should require the Supervisor to document his or her approval on each rehabilitation project description of work.

**The Housing Department Does Not Evaluate
Contractor Performance As A Basis For Deciding
Whether To Continue Using The Same Contractors In The Future**

The Housing Department maintains information on eligible contractors. Each contractor file contains the contractor's application to do business with the City and the most recent evidence of its contractor's license, liability insurance, and worker's compensation insurance. Additionally, the files contain background checks on the contractors. However, the files do not include an evaluation of the contractor's performance. As a result, the Department's ability to exercise its contractor selection authority is impaired and the Department may continue to do business with contractors who have not performed satisfactorily.

Authoritative literature cites the importance of using contractor performance history in qualifying potential bidders and selecting the contractor. The book *Managing Construction Contracts* by Robert Gilbreath, states:

Few things would be worse than allowing an unstable contractor to perform contract work. Whether it is financially unstable, has a history of poor performance, or has demonstrated a penchant for disputes and claims, it is

much better to discover this beforehand and prevent this contractor from bidding than to deal with it as a project contractor.

In our opinion, the Housing Department should establish a process for evaluating contractor performance and use the information from contractor performance evaluations as a basis for deciding whether to use the same contractor in the future.

**Neither The Housing Department Nor The Finance
Department Are Fully Reconciling Subsidiary
Rehabilitation Loan Ledgers And Other Detail Loan Listings
To The City's General Ledger Or To Each Other**

The Finance Department currently maintains the subsidiary ledgers of both amortized and deferred outstanding rehabilitation loans. However, the Housing Department accounting staff and U.S. Escrow (USE), the City's rehabilitation loan servicing agent, also maintain detail loan activity listings. The Finance Department utilizes the USE and Housing Department loan listings to create the subsidiary loan ledgers. Our review indicated that although the subsidiary loan ledgers reconcile to the general ledger, the other detail loan listings are not fully reconciled to the City's general ledger accounts or to each other. We did note that the Finance Department performs monthly reconciliations and that both the Finance Department and the Housing Department perform mid-year and year-end subsidiary ledger reconciliations. However, in our opinion, these reconciliation procedures are not always documented and may be duplicative in some ways.

The City's independent auditor made similar observations. In its November 7, 1991, *Comments and Recommendations on the Internal Control Structure*, KPMG Peat Marwick observed:

Timely reconciliations of Housing Department loan portfolio subledgers to the general ledger are not being performed. . . . Timely reconciliation of loan portfolio detail to the general ledger is an important control to ensure the accuracy of recorded loan balances.

Therefore, KPMG Peat Marwick recommended that:

Loan portfolio subledgers be reconciled to the general ledger on a monthly basis. These reconciliations should be documented. When there are differences between Housing Department recorded balances and those reflected in the general ledger, Housing Department personnel should initiate actions to investigate and correct them as soon as possible. [Emphasis added.]

Our review revealed the following regarding reconciliation procedures for subsidiary rehabilitation loan records:

1. The Housing Department is not documenting the reconciliation of the Housing Department's Construction Disbursement Record to the USE check stub. Currently, the Account Clerk performs the reconciliation but does not document it. Without such documentation, management cannot ascertain that the staff performs the reconciliation regularly and promptly resolves any unusual items.
2. The Housing Department is not performing detailed project-by-project reconciliations of Housing Department project records to USE monthly reports. The Account Clerk scans the USE monthly Escrow Status Report for unusual items. Although this report shows the activity and balance for each project, the Account Clerk does not perform a project-by-project account reconciliation between this report and the Construction Disbursement Record. Therefore, the Escrow Status Report may contain some unusual items or unposted current activity that would not be noticed in the current procedure.

3. The Finance Department's monthly reconciliation of USE records to the City subsidiary ledger is not fully documented. The Finance Department performs a monthly reconciliation of the USE Portfolio Status Report to the balance on the City subsidiary ledger. However, the Finance Department does not fully document this reconciliation. Reconciling items result from (1) deferred loans remaining on the City subsidiary ledger of amortized loans that are no longer recognized by USE, (2) new loans recognized by the City subsidiary ledger but not yet recognized by USE, and (3) the initial loan payments held as a reserve against bounced checks recognized by USE but not by the City. Documentation of the reconciliation will assist in follow-up of reconciling items.
4. The Finance Department's monthly reconciliation of USE records to the City subsidiary ledger is not utilizing the USE report for the same month. The Finance Department uses the most currently available report. Due to slow transmittal time, the report used is one month behind the City's "as of" reconciliation date. However, for its monthly reconciliation, the Finance Department should utilize the USE report of the same month for which the City's ledger is being reconciled. This will provide the most accurate financial information about items which either the City or USE may not be posting correctly in the current period.

Additionally, our review indicated that the Housing and Finance Departments could improve efficiency by eliminating duplicative records. Currently, the Housing and Finance Departments maintain several detail loan listings that provide the same information. In our opinion, the City needs only one detail loan listing to serve as an official subsidiary ledger. The existing detail loan listings, which are in part duplicative, include:

- The Finance Department's subsidiary ledgers for both amortized and deferred loans;
- USE's detail listing of amortized loans; and

- The Housing Department's detail listings of loan balances for both amortized and deferred loans.

It should be noted that the City plans to obtain a third-party review of USE operations. This will facilitate (1) reliance upon USE loan listings as a subsidiary amortized loan ledger, (2) eliminate the need for Housing and Finance to maintain duplicate loan listings, and (3) eliminate the need for both Housing and Finance to monitor the USE subsidiary ledger.

To improve their rehabilitation loan accounting, the Housing Department and Finance Department should eliminate duplicative detail loan listings and perform and document complete reconciliations on a monthly basis.

**The Housing Department Does Not Have
A Policy To Identify And Write Off Uncollectible Loans**

The Housing Department has a Loan Default Policy that defines types of loan defaults and gives remedies by loan category. However, it does not provide criteria for writing off uncollectible loans. Generally accepted accounting principles dictate that the receivable balances, after deducting an allowance for uncollectible accounts, should reflect reasonably realizable amounts.⁹ Accordingly, the City has set up a loan loss reserve allowance for uncollectible rehabilitation program loans that the City's independent auditor, KPMG Peat Marwick, has found acceptable.

However, the amount reserved for a loan increases as its probability of being collected decreases. Individual loans may be eventually reserved at 100 percent.

⁹ *Handbook of Accounting and Auditing*, Second Edition, by Robert Kay and Gerald Searfoss, pages 13-51.

According to KPMG Peat Marwick, these are loans with the highest level of risk loss and are "*essentially unrecoverable expenditures.*" Further, these are "*loans which management believes have no likelihood of the borrower repaying and for which there is no collateral for the City.*"¹⁰

We found that the Housing Department has not established a policy or procedure to identify and write off as uncollectible any loans. According to Housing staff, "*Rather [than writing off loans], the Department takes appropriate action to collect on loans in accordance with the borrowers' loan documents. ...It is Department procedure to investigate and exhaust all remedies on loan repayments including a restructuring of the loan and adjustment to the payment schedule, increasing loan payments or converting an amortized loan into a deferred loan.*" As a result, the City may indefinitely carry on its books loans that are patently uncollectible.

The Housing Department's intent is to use all available legal means to collect on loans, although they may appear to be uncollectible. However, while generally accepted accounting principles allow for writing off currently uncollectible accounts, that does not mean that all collection action necessarily ceases. "*Even though a specific customer's account is written off, collection efforts will normally continue.*"¹¹ Thus, the Department's policy to exhaust all remedies to pursue loan repayments is not contradictory to recognizing and writing off uncollectible loans. It does probably mean, however, that such collection actions would most likely be

¹⁰ *Strengthening the Credit Management Process: Final Project Team Recommendations*, September 1988.

¹¹ *Intermediate Accounting: Concepts, Methods, And Uses*, Third Edition, by Davidson, Stickney, and Well, pages 7-10.

extraordinary rather than routine. Also, any repayments obtained after the loan has been written off should be accounted for as a recovery.

Therefore, in our opinion, the Housing Department should develop and implement a policy regarding uncollectible loans, including specific criteria and procedures for identifying uncollectible loans that should be written off.

**The Housing Department's
Electronic Data Processing (EDP)
Contingency Plan Is Not Adequate**

In its July 1991 response to a Citywide request from the Office of Emergency Services for departmental EDP contingency plans, the Housing Department stated that there were "*no absolutely essential computerized departmental functions that would require detailed contingency plans.*" Consequently, the Department did not prepare an EDP contingency plan for the Office of Emergency Services.

As part of our audit, we identified computer systems used for the Housing Rehabilitation Programs. These included the Citywide Financial Management System (FMS) and VAX computer system, a Local Area Network (LAN) of personal computers, stand-alone personal computers, and those computer systems used externally by USE. In our opinion, the Housing Department should have an internal EDP contingency plan to cover its LAN, stand-alone personal computers, and those computer systems used by USE. This is necessary to protect City assets (including loans receivable), to protect vital records maintained on EDP systems, and to recover records damaged or destroyed due to interruptions or disasters.

CONCLUSION

The Housing Department has identified and implemented most of the internal controls needed to mitigate the threats we identified during our risk assessment of the Housing Rehabilitation Programs. However, our review has indicated that the Department still needs to develop or improve certain controls to ensure that the City is adequately protected. The Housing Department can improve its system of internal controls over its Housing Rehabilitation Programs by (1) documenting contractor pre-screening interviews, bid evaluations, and description of work approvals, (2) evaluating contractor performance, (3) coordinating with the Finance Department to eliminate duplicative detail loan listings and fully reconcile rehabilitation loan subsidiary ledgers to the City's general ledger, (4) developing a policy to identify and write off uncollectible loans, and (5) preparing an EDP contingency plan covering all the major computer systems used by the Department.

RECOMMENDATIONS

We recommend that the Housing Department:

Recommendation #4:

Use a checklist of topics to be discussed at the contractor pre-screening interviews and request each contractor applicant to sign the checklist. The signed checklist should be retained in the Department's contractor files. (Priority 3)

Recommendation #5:

Require Rehabilitation Inspectors to document the performance of line item comparisons of the contractor bids submitted to the Department's cost estimate. (Priority 3)

Recommendation #6:

Require the Rehabilitation Supervisor to document his or her approval on each rehabilitation project description of work. (Priority 3)

Recommendation #7:

Establish a process for evaluating contractor performance and use the information from contractor performance evaluations as a basis for deciding whether to use the same contractor in the future. (Priority 3)

Recommendation #8:

Coordinate with the Finance Department to eliminate duplicative detail loan listings and perform and document complete reconciliations of subsidiary rehabilitation loan ledgers to the City's general ledger on a monthly basis. (Priority 2)

Recommendation #9:

Develop and implement a policy regarding uncollectible loans, including specific criteria and procedures for identifying and writing off such loans. (Priority 3)

Recommendation #10:

Develop and implement disaster recovery and contingency plans for all critical information maintained in electronic data processing systems either on-site or off-site. (Priority 3)

FINDING III

THE HOUSING DEPARTMENT NEEDS TO COMPLETE THE DOCUMENTATION OF ITS POLICIES AND PROCEDURES

Written policies and procedures are an essential part of an organization's internal control structure. Policies are general statements that guide thinking and action in making decisions. Procedures detail the manner in which the staff should perform their duties in implementing the policies. Policies and procedures should be in writing to (1) reduce the need for managerial direction of routine matters, (2) improve efficiency through standardization of actions, (3) facilitate the training of personnel, and (4) document institutional knowledge so that operations can continue in the absence of key employees.

Our review of the Housing Department's internal controls disclosed that:

- The Department needs additional documentation of controls relating to its Housing Rehabilitation Programs;
- The Rehabilitation Unit has not fully documented the reports it prepares or uses in connection with the Rehabilitation Programs; and
- In March 1992, the Department issued a draft of the *Rehabilitation Program Handbook*, designed to document the policies and procedures for the various Rehabilitation Programs. However, the handbook is still incomplete with regard to certain aspects of the programs.

The Housing Department can improve its policies and procedures documentation by (1) preparing or completing its documentation of its internal controls for the Rehabilitation Programs, (2) using the controls listing presented in this report (Appendix E) to identify which of its internal controls still require complete documentation, (3) completing its inventory and documentation of the

reports it prepares or uses in connection with the Rehabilitation Programs, and (4) setting a target date for issuing its *Rehabilitation Program Handbook*.

The Benefits Of Written Policies And Procedures

Written policies and procedures are an essential part of an organization's internal control structure. "*Policies are general statements that guide thinking and action in decision-making.*"¹² Procedures detail the manner in which staff should perform their duties in implementing the policies. Procedures consist of a set of specific steps in chronological order and serve as a guide to action.

The advantages of having policies and procedures are that they (1) reduce the need for managerial direction of routine matters, (2) improve efficiency through standardization of actions, (3) facilitate the training of personnel, and (4) document institutional knowledge so that operations can continue in the absence of key employees. To be useful, policies and procedures must be in writing so that they are clearly delineated and yet flexible enough to be adaptable to new situations. By keeping them in manuals, the Housing Department can make policies and procedures easily accessible to staff.

The Housing Department Needs Additional Documentation Of Controls Relating To Its Housing Rehabilitation Programs

As part of our risk assessment of the Housing Department's Rehabilitation Programs, we interviewed Housing staff and reviewed the available documentation of internal controls. The risk matrix shown in Appendix D summarizes our review

¹² Certified Internal Auditor Examination Review, Irvin N. Gleim

and the controls listing in Appendix E identifies the controls that still lack any type of documentation.

In general, the Housing Department needs to prepare or complete the documentation of its internal controls for the Rehabilitation Programs in the following areas:

- Tracking of loan processing;
- Loan monitoring procedures (including the computerized database of loan information);
- Standardized Loan Committee loan packages;
- Coordination with U.S. Escrow (USE);
- Subsidiary loan ledger reconciliations;
- Rehabilitation Inspector procedures and guidelines;
- Paint Rebate Program procedures;
- Contractor conflict of interest issues; and
- Departmental code of ethics.

**The Rehabilitation Unit Has Not Fully Documented
The Reports It Prepares Or Uses In Connection
With The Rehabilitation Programs**

The Rehabilitation Unit prepares or receives various reports in connection with the operation of the Rehabilitation Programs. Our review of the documentation of internal controls included a review of procedures for preparing and using the various reports. We noted that the Housing Department Rehabilitation Unit has started to document an inventory of the reports it prepares

or receives by indicating the purpose of the report and listing the persons to whom the report is to be distributed.

The reports for which the Rehabilitation Unit needs to complete its documentation include the following:

- Rehabilitation Team loan application status reports;
- Monthly loan approval tracking reports;
- Periodic reports to the Housing and Community Services Committee;
- Periodic reports to the Housing Advisory Commission;
- Quarterly delegation of authority report to the City Council; and
- Loan accounting reports (for example, monthly USE activity reports).

The Rehabilitation Unit has not completed the documentation for some of these reports because the report format is currently being designed or revised. In other instances, the Unit is in the process of changing the procedures relating to the report.

The Rehabilitation Unit can improve its documentation of reports by compiling samples of the reports in a Reports Inventory. The Reports Inventory would show copies of representative pages of the report and indicate the purpose of the report, who prepares it, what the sources of the information are, to whom it is to be distributed, what action is to be taken as a result of the report, and how long the Department is to retain it. The Reports Inventory would be useful not only in informing the Department staff of the types of reports and information available, but also in identifying any duplicative reports.

The Rehabilitation Program Handbook Is Still Incomplete

The Rehabilitation Unit of the Housing Department prepared a draft of the *Rehabilitation Program Handbook*, which describes and documents the majority of the Rehabilitation Program's internal controls. The documentation for other internal controls is contained in procedures, guidelines, contracts, and other types of written evidence the Administration Division and other sections of the Department maintain.

The Housing Department should set a target for issuing the *Rehabilitation Program Handbook* and use the controls listing presented in this report (Appendix E) to identify which of its internal controls still require complete documentation.

CONCLUSION

Our review of the Housing Department's internal controls disclosed that the Department has not completely documented its controls over its Rehabilitation Programs and that the Rehabilitation Unit has not fully documented an inventory of the reports it prepares or uses in connection with the programs. The Department should prepare or complete its documentation of internal controls for the Rehabilitation Programs and use the controls listing presented in this report to help complete its documentation of internal controls. The Department should also complete its inventory and documentation of the reports it prepares or uses in connection with the Rehabilitation Programs. Finally, the Department should set a target for issuing the *Rehabilitation Program Handbook*.

RECOMMENDATIONS

We recommend that the Housing Department:

Recommendation #11:

Prepare or complete the documentation of its internal controls for Rehabilitation Programs in the following areas:

- Tracking of loan processing;
- Loan monitoring procedures (including the computerized database of loan information);
- Standardized Loan Committee loan packages;
- Coordination with U.S. Escrow;
- Subsidiary loan ledger reconciliations;
- Rehabilitation Inspector procedures and guidelines;
- Paint Rebate Program procedures;
- Contractor conflict of interest issues; and
- Departmental code of ethics.

(Priority 3)

Recommendation #12:

Use the controls listing presented in this report to help complete the documentation of its internal controls for the Rehabilitation Programs.

(Priority 3)

Recommendation #13:

Complete its inventory and documentation of the reports the Housing Department prepares or uses in connection with the Rehabilitation Programs.
(Priority 3)

Recommendation #14:

Set a target date for issuing the *Rehabilitation Program Handbook*.
(Priority 3)

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